

The Credit Union Industry— An Overview

by Barbara A. Good

Credit unions play a crucial role in the U.S. financial industry, serving more than 68 million people. Although the percentage of assets under their control is dwarfed by that of commercial banks, credit unions have some unique characteristics and have evolved into increasingly competitive, customer-oriented providers of financial services. Their growth rate during this decade has been noteworthy: While commercial banks' share of industry assets has declined, credit unions have experienced significant growth.

One special feature of the market is the corporate credit union; before January 1995, few outsiders had ever heard of one. Although corporate credit unions achieved a moment of fame with the demise of Capital Corporate Credit Union in Lanham, Maryland, which handled the investments of the White House Employees and Pentagon Employees Credit Union, most people are still unfamiliar with credit unions' role in the financial marketplace. To understand their purposes and functions, one must understand the structure of the industry and the regulatory environment under which it operates.

■ Natural-Person Credit Unions

Like commercial banks, mutual savings banks, and thrifts, credit unions are depository financial intermediaries. By statute, they have historically been restricted to providing services only to the consumer market, in the form of savings accounts and personal loans. Their services are not available to the general public, since their charters require a business plan directed at groups that have a common bond, such as occupation, association, or residence. They are legally designated as "natural-person" credit unions, because their members are individuals. From a financial standpoint, the tax benefits that most credit unions enjoy are the chief difference between them and other financial service providers.

Credit unions date back to mid-nineteenth-century Germany, and the concept migrated to the United States in the early 1900s. In 1909, the first credit union gained legal status in Manchester, New Hampshire, through a special act of the state legislature. Massachusetts passed the first credit union law the same year. The Massachusetts law defined a credit union as a "cooperative association formed for the purpose of promoting thrift among its members," and adopted the principle of member deposits financing member loans.¹

The rapid development of consumer activism and labor organizations during this time dovetailed with the credit

In recent years, the credit union industry has grown faster than any other financial intermediary, adding more than \$100 billion in assets between 1988 and 1995. Still, many people remain unfamiliar with credit unions' purposes and functions. This *Economic Commentary* introduces readers to the industry's structure and regulatory environment, and takes a brief look at some safety and soundness issues.

unions' "common bond" concept. The new institutions were welcomed as an alternative to loan sharks as well as traditional financial establishments like banks and building societies. The industry experienced real growth in the 1920s, in tandem with the general prosperity of that time. Later on, expansion resulted from improving economic conditions, legislation, and changing demographics, as well as the 1934 passage of the Federal Credit Union Act. In recent times, this industry has grown faster than any other financial intermediary; it now serves more than 68 million customers.²

Though overshadowed by commercial banks, thrifts, and other banking-type companies, credit unions are emerging as attractive choices. At the end of 1995, 11,887 credit unions were operating in the United States, with aggregate assets of \$312 billion (see figures 1 and 2).

Although consolidations and closures in the last decade reduced the number of credit unions, this sector's assets continue to grow at a faster rate than those of commercial banks (see figure 3). Credit unions now outnumber commercial banks, although their aggregate assets total less than a tenth as much. In 1995, assets held by all credit unions grew 5.1 percent, continuing a long expansionary trend.

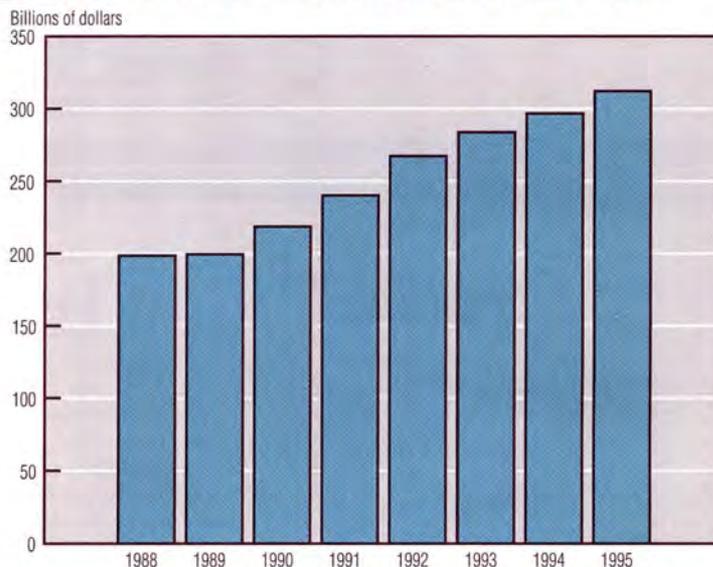
Like banking companies, credit unions have a dual charter system—federal or state. Charters generally establish rules for application requirements, purpose, membership, branching, and regulatory supervision.

■ Corporate Credit Unions

The credit union industry has many tiers: credit unions, local chapters and state leagues of credit unions, corporate credit unions, a national credit union "bankers' bank," and national trade associations. Regulatory structures consist of a federal agency, a liquidity branch of that agency, and state regulators.

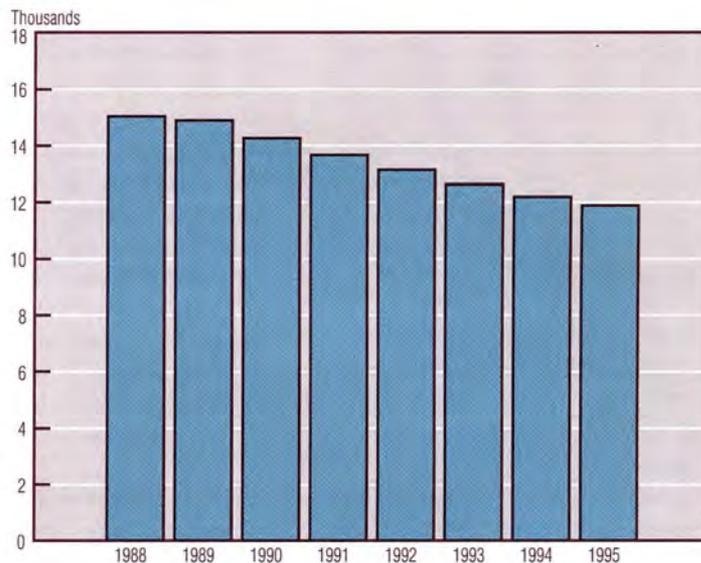
A corporate credit union (CCU) is a credit union for credit unions, providing investment, settlement, and liquidity services for its members. Most natural-person credit unions belong to a CCU

FIGURE 1 INSURED ASSETS OF U.S. CREDIT UNIONS



SOURCES: *American Banker*, "Top 100 Credit Unions" (footnote 2); Callahan & Associates; and Credit Union National Association.

FIGURE 2 NUMBER OF U.S. CREDIT UNIONS



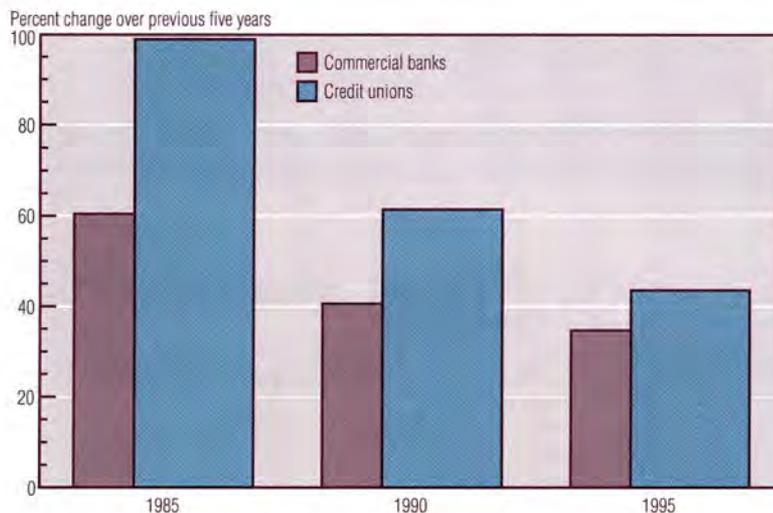
SOURCES: *American Banker*, "Top 100 Credit Unions" (footnote 2); Callahan & Associates; and Credit Union National Association.

and maintain deposits there. At the end of 1995, there were 42 CCUs, of which only five were not federally insured.

A CCU also serves as a bankers' bank for credit unions, accepting deposits and lending to them when loan demand is high. CCUs also provide their members with check clearing, automated clearing-house processing, and other services, and function as a credit union clearinghouse.

The U.S. Central Credit Union (USC) in Overland Park, Kansas, was established in the 1970s as a central credit union for the benefit of its members, including CCUs, state credit union leagues, and affiliated organizations. The USC and the 42 CCUs are known as the Corporate Credit Union Network. The USC's principal activity is to provide wholesale investment, liquidity, custody, and payments system services to its members,

FIGURE 3 GROWTH OF ASSETS



SOURCE: Board of Governors of the Federal Reserve System, *Flow of Funds Accounts*, September 13, 1995 and March 8, 1996.

and, in turn, to their member credit unions. The USC's investments have historically been highly liquid, consisting primarily of Treasury bonds and other government agencies' issues.

In 1980, the Monetary Control Act gave the USC, CCUs, and credit unions access to Federal Reserve Bank services. The USC and CCUs are not permitted to incur daylight overdrafts unless they become eligible to borrow at the discount window by voluntarily holding reserves with a Federal Reserve Bank.

■ Government Regulation of Credit Unions

The regulatory framework for credit unions is similar to that for banks and thrifts, because of the dual chartering system. State-chartered credit unions are examined and supervised by state agencies, while federally chartered credit unions are examined and supervised by the National Credit Union Administration (NCUA), an agency of the federal government. The NCUA also examines state-chartered, federally insured institutions. In addition to chartering, supervising, examining, and insuring federal credit unions, the NCUA insures the accounts of state-chartered credit unions that voluntarily exercise the option to be federally insured, or are required by state law to be so.

The NCUA is funded by credit unions through fees and assessments; their relationship is like that between national banks and the Comptroller of the Currency. Two operations of the NCUA aid in credit unions' insurance, liquidity, and liquidation. These are the National Credit Union Share Insurance Fund (NCUSIF) and the Central Liquidity Facility (CLF).

Accounts in federally chartered credit unions were uninsured until 1970, when President Nixon signed a law providing such insurance and establishing the NCUSIF. All federal credit unions were required to be insured, and state-chartered credit unions could obtain this insurance at their option, if they satisfied the criteria established by law. The NCUSIF is capitalized by its member credit unions, which are obliged to contribute an amount equal to 1 percent of their insured shares. In addition, a reserve fund protects against any losses that exceed the amounts reserved exclusively for liquidating failed credit unions.

The CLF was created when the Financial Institutions Regulatory and Interest Rate Control Act of 1978 authorized the NCUA to establish and oversee it. The CLF was designed to be a central bank

and lender of last resort, which credit unions did not have at that time. Before it was established, corporate credit unions were used as primary credit facilities. The creation of the CLF made government-sponsored funding available to the credit unions. CLF funding is intended to be sought by troubled credit unions only for short-term liquidity problems, not for expansion or other purposes.

The CLF is a quasi-public organization that provides liquidity to credit unions by borrowing from public sources. Its borrowing limit is calculated by a complicated formula based on equity and capital. In the early 1990s, the U.S. General Accounting Office estimated that the CLF had authority to borrow up to \$10.9 billion. The CLF, which is backed by the full faith and credit of the U.S. government, has an additional line of credit from the Treasury—\$100 million as a direct line and a \$500 million back-up letter of credit, contingent on congressional approval.

■ Credit Unions—The Future?

In general, natural-person credit unions are in sound financial health. Although more thinly capitalized than commercial banks, their investment portfolios are generally less risky than those of same-size commercial institutions. Early in 1995, however, concern arose about the investment portfolios of natural-person credit unions, because about 10 percent of them were holding approximately \$7 billion of collateralized mortgage obligations (CMOs).³

By contrast, CCUs have historically had very low capital/asset ratios, and many have significant investments in financial instruments that are considered to pose a higher-than-standard risk. In April 1995, the NCUA attempted to address this concern by releasing its proposed regulation to strengthen the capital ratios of CCUs, reduce the risk of their investments, and improve asset-liability management. This proposal said that its provisions "would return corporate credit unions to their primary function of serving as liquidity centers and service providers, and would protect the safety and soundness of the corporate credit union system."⁴

In light of industry objections, the NCUA decided to rescind this proposal and announced its intention last July to issue a revision and obtain a second round of comments. The revised proposal will soon be published in the *Federal Register*.

■ Conclusion

This *Commentary* has introduced readers to credit unions' history and function, and to the industry's structure and regulatory environment. Some important subjects for future analysis might include changes in the investment portfolios of both natural-person and corporate credit unions over the last two years, and the potential impact of increased capital requirements on credit unions' growth and profitability.

■ Footnotes

1. For a detailed examination of the origins of the credit union movement, see J. Carroll Moody and Gilbert C. Fite, *The Credit Union Movement: Origins and Development: 1850-1970*, Lincoln: University of Nebraska Press, 1971. For a look at the history of the U.S. credit union industry, see Alane K. Moysich, "An Overview of the U.S. Credit Union Industry," *FDIC Banking Review*, vol. 3, no. 1 (Fall 1990), pp. 12-26.

2. See "Top 100 U.S. Credit Unions," *American Banker*, April 8, 1996, p. 8.

3. See Joseph G. Haubrich, "Derivative Mechanics: The CMO," Federal Reserve Bank of Cleveland, *Economic Commentary*, September 1, 1995.

4. See "Corporate Credit Unions: Requirements for Insurance," *Federal Register*, vol. 60, no. 80 (April 26, 1996), p. 20,438; and Proposed Rules, 12 C.F.R., pts. 704 and 741.

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